Comments for the Record
U.S. House of Representatives Committee on Ways and Means
U.S. Senate Committee on Finance
Joint Hearing on Tax Reform and the Tax Treatment of Capital Gains
Thursday, September 20, 2012, 10:00 AM

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Chairmen Camp and Baucus and Ranking Members Levin and Hatch, thank you for the opportunity to submit these comments for the record to this joint hearing. As an addendum to the comments to this topic, please see a brief treatment of two prior hearings for which the record has already closed having to do with the implementation of the Affordable Care Act. As always, our comments are in the context of our proposed comprehensive tax reform. As you know, the Center for Fiscal Equity proposal includes four major provisions:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure that every American family pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

As we pointed out to the Senate Finance Committee one year ago and as Bruce Bartlett points out in his recent book, *The Benefit and the Burden*, in other OECD countries, all of whom have consumption taxes, capital gains taxes can be lower, since a portion of the taxation of capital already occurs as part of the VAT. The logic to enact lower capital gains and dividend taxes outside of a consumption tax environment is not as strong.

The Center for Fiscal Equity believes that lower dividend, capital gains and marginal income taxes for the wealthy actually destroys more jobs than they create. This occurs for a very simple reason – management and owners who receive lower tax rates have more an incentive to extract productivity gains from the work force through benefit cuts, lower wages, sending jobs offshore or automating work. As taxes on management and owners go down, the marginal incentives for cost cutting go up. As taxes go up, the marginal benefit for such savings go down. It is no accident that the middle class began losing ground when taxes were cut during the Reagan and recent Bush Administrations, both of which saw huge tax cuts. Keeping these taxes low is also part of why we are experiencing a jobless recovery now.

As long as management and ownership benefit personally from cutting jobs, they will continue to do so. Tax reform must reverse these perverse incentives.

In order to preserve vertical equity in a given tax year in a consumption tax environment, some form of progressive income and inheritance taxation is essential, otherwise the debt crisis cannot be avoided as consumption taxes will never be adequate to replace the lost revenue.

The Center suggests retaining surtaxes on high income earners and heirs. These would replace the Inheritance or Death Tax by instead taxing only cash or in-kind distributions from inheritances but not asset transfers, with distributions remaining tax free they are the result of a sale to a qualified Employee Stock Ownership Plan. This proposal applies to inherited income, where not only the capital gain from the asset but the sales price of the asset itself will be considered income upon liquidation – but only to the extent that it increases income over the $100,000 floor. No family farm or business need be sold to pay taxes – indeed, the opposite incentive will operate since unsold inherited assets will remain untaxed under our proposal.

Identifying deficit reduction with income and inheritance surtaxes recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

In testimony earlier this year before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay surtaxes on that income.

The Center considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

To summarize, we propose that capital gains be fully taxed as normal income, however the vast majority of tax paying units will not pay taxes on such gains at all because they report less than $100,000 in income (after gross income is reduced to account for the shift of most taxation to consumption taxes). We believe that unless dividend, capital gains and high wage taxes are all the same that a variety of economically inefficient schemes to avoid taxes will continue. Only parity takes away the incentive to income in one category or another (for example, manipulation of share price rather than paying dividends).

Thank you for the opportunity to share these views with both Committees. Now, please indulge us in putting our comments into the record regarding taxation issues related to the implementation of the Democrat's Health Care Law, more politely referred to as the *Affordable Care Act.*

On the issue of the extension of the Hospital Insurance Tax and additional payroll taxes to high wage income over $250,000 per year for families, such taxation essentially imposes a consumption tax. This is especially the case because the vast majority of this type of income eventually goes to families in these income strata. Whether this is a clever way to only make the benefiting households pay or will turn into an inflationary tax on workers and consumers depends upon the market power of investors to preserve their level of personal income by either raising prices on the commodities that produce this income or cutting wages for their employees to make up the difference.

Recent analysis by the Tax Policy Center estimates that 20% of the burden of paying corporate income taxes actually apply to wages, with 60% being born by shareholders. We suggest that the same rationale might be applicable here, although TPC ignores the impact of the corporate income tax on market prices, which we believe is mistaken due to the degree of market concentration in the consumer economy.

The bottom line is, the new surtax in the Affordable Care Act will work its way into the labor and product markets, although in an economy where deflation is under reported, this is probably not a bad thing.

On the issue of the implementation of health insurance exchanges, I believe some degree of delay can be pardoned. Until the recent Supreme Court case was resolved affirming the constitutionality of the Act, efforts to create exchanges would have been a vast waste of time had the Court ruled the other way. Indeed, they may still well be, as we believe that the stock market has not yet priced in the implementation of pre-existing condition reforms in relation to the weakness of the mandates in the law.

At some point, analysts will ask the following question: ***"Who is more risk averse, investors or the uninsured?"*** If the answer is the uninsured, then the provisions of the law will indeed work as planned and exchanges are a necessary part of the deal. On the other hand, if the answer is investors, then the market for health insurance stocks is about to tumble, sending these companies into receivership which will likely resolve itself into some form of single-payer health plan which will make the efforts to set up exchanges a colossal waste.
Of course, Congress could act prior to such a stampede and set up a tax subsidized public option for those who either cannot afford coverage or cannot obtain it due to pre-existing conditions in exchange for the repeal of mandates and guaranteed issue. Eventually, as the demand for ever increasing profits will force more and more people into the public option, as such demands are endemic to modern capitalism. At some point, all of the people who need insurance will be in the public option and the private insurance market will be a luxury item.

In both cases, single-payer insurance and a public option are best funded by the Net Business Receipts Tax described above and in greater detail over the last two years in comments to both revenue committees.

We expect that because of the election recess and the fast pace of any Lame Duck session this will be the last time the Center has to opportunity to provide comments to both of these committees. We wish to congratulate the both for an exiting exploration into the possibilities of tax reform. In a Congress which the media has reported as being mired in gridlock, your agendas have provided a ray of hope for continuing bipartisanship. We would hope that while Members and Senators are out on the political circuit, as they must be to enliven our democracy, staff can hold serious discussions on tax reform with the Administration, just in case a deal can be made after November 6th.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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